Global Debt Outlook

Invesco Fixed Income
Q2 2021

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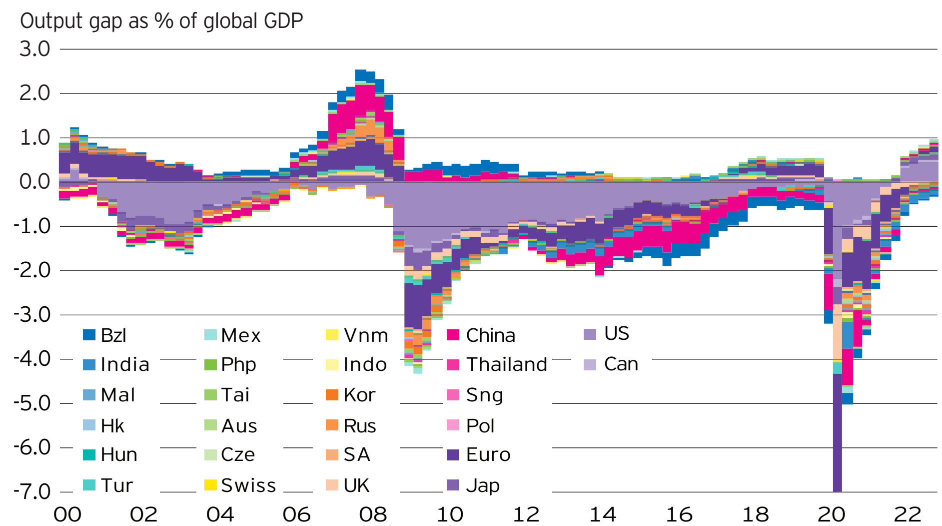
Reflation is the theme - reflationary assets should benefit

A global recovery is well underway, with growth estimates for 2021 being raised across the board. Our own growth estimates for the US, eurozone, and selected emerging market countries have moved toward the top end of our forecast ranges. This indicates our growing confidence that this year's global growth could be the best in over a decade. While the initial upswing will likely be led by the US and emerging markets, especially Asia and China, an expected upswing in Europe will probably extend the recovery to a true, global reflationary boom.

The major risk factor for global growth, in our view, is China. We see upside risk to our Chinese growth estimate of 8.5% (on the back of massive US fiscal stimulus), which is already at odds with the Chinese government's official estimate of around 6% average annual growth under its five-year plan. This discrepancy is unusual since, for the last decade, markets have grappled with the opposite situation – reconciling consensus growth estimates that are below official Chinese forecasts. However, China's five-year plan estimates are not growth forecasts but a reflection of official policy goals intended to avoid the excess leveraging mistakes following the global financial crisis and an acknowledgment that long-term growth in China is on a declining trend. Nevertheless, improved global growth forecasts still imply that the global economy will not achieve its trend output until 2022, and, therefore, inflation is not likely to be a significant concern. While recent inflation has been dominated by rising goods prices, the coming boom is likely to be focused on services, where we believe the output gap is too large to result in immediate inflationary pressures.

Figure 1: Global output gap as percentage of global GDP - by country contribution



Source: UBS. Actual data from March 2000 to December 2020. Forecast data thereafter. GDP is gross domestic product. Countries are Brazil, India, Malaysia, Hong Kong, Hungary, Turkey, Canada, Mexico, Philippines, Taiwan, Australia, Czech Republic, Switzerland, US, Vietnam, Indonesia, Korea, Russia, South Africa, UK, China, Thailand, Singapore, Poland, Europe, Japan.

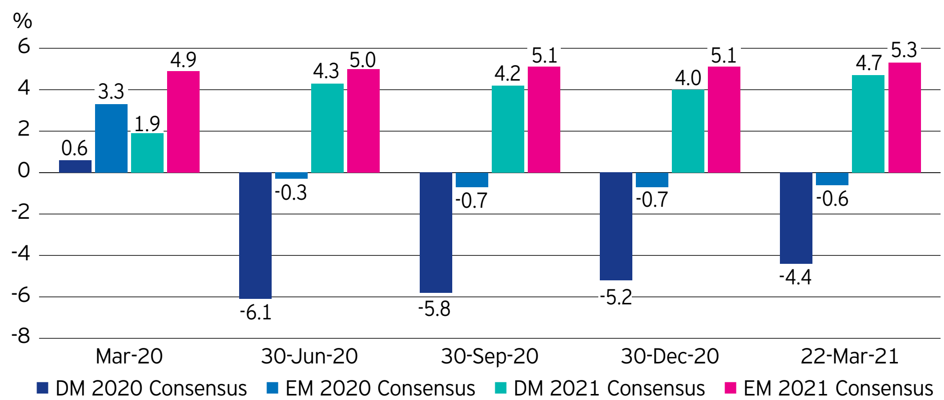
A fifth "p" is added to our "four-p" framework (pandemic, policy, pricing, portfolio positioning)

We have added a fifth "p" to our four-p framework: "path dependency." Path dependency is the relative unwillingness to change a given course of direction or action. Our view is that the US Federal Reserve (Fed) will not change its already embarked upon, established course of easy monetary policy. Going forward, we believe the evolution of the (now) five p's during this global reflation will determine the attractiveness of the different fixed income asset classes.

Evolution of the first two p's (pandemic and policy) is critical

While we hope that we will stop talking about the pandemic in the coming quarters and revert to the four p's, the pandemic remains of significant relevance to markets. Fortunately, our focus has broadened from the pandemic to the rollout of global vaccine programs. The UK and US are leading the way among developed countries, while Asia is lagging significantly, which is a shift from the success it originally had in dealing with the disease. The vaccine rollout has been especially chaotic in Europe, which has resulted in a delayed economic recovery. Emerging markets present a mixed picture, with several economies, such as India, reopening fully, while in Brazil and Mexico, the pandemic is still raging unabated. In general, the emerging countries are likely to lag developed markets; however, it is unclear if this will negatively impact their economic prospects. We expect most emerging economies to reopen regardless of the pandemic. Their economic performance is, therefore, expected to be relatively robust, which was already seen in the fourth quarter of 2020. The global economy, in general, outperformed expectations, led by upside surprises in the US, but also in a broad swath of emerging countries, such as India and Brazil.

Figure 2: GDP consensus forecasts - developed markets versus emerging markets



Source: Bloomberg L.P. Data from March 30, 2020, to March 22, 2021. EM is emerging market. DM is developed market.

Easy monetary and fiscal policy to continue for foreseeable future

The global monetary and fiscal policy response to the pandemic has been overwhelming and will likely continue to be so, despite the recent market wobble on interest rates. In its March 17 meeting, the Fed pushed back aggressively on the market's attempt to reprice its path. The Fed's response, combined with similar messages from the European Central Bank, the Reserve Bank of Australia, and the Bank of Canada, made clear that monetary policy will remain exceptionally accommodative for the foreseeable future. We do not expect any major developed market central bank to tighten policy prior to 2023. We also expect the market to probe these central bank commitments, but believe it is unlikely that the Fed, or any other central bank, will be easily swayed into changing its stance. Central banks in developed markets have become more reactive and will likely need to see significantly higher and self-sustaining inflation, especially through wage increases, before tightening financial conditions.

In emerging markets, we have seen some changes, including the Central Bank of Brazil's first rate increase in six years, suggesting that current extraordinarily easy monetary conditions may no longer be needed. In addition to Brazil, there may be a few countries that reduce policy accommodation over the next 12 months, but these actions should not change market expectations that monetary policy will remain generally accommodative globally. When central banks finally do move to raise interest rates, we believe it is unlikely that any bank will surprise markets with policy tightening significantly beyond market expectations. The future path of rate increases will likely be critical in extracting excess returns from markets. We believe excess premia that are priced in, in response to a rapid monetary policy reaction, would likely be easily extracted from the market, though with higher volatility than optimally desired.

Our expectation of accommodative fiscal policy, but with declining magnitude, has been altered by the massive US fiscal stimulus announced in March. We continue to anticipate a positive fiscal impulse to global growth, led by the US, but with an added boost from countries like India that have emphasized growth in the near term over fiscal discipline in an effort to grow out of their deficits.

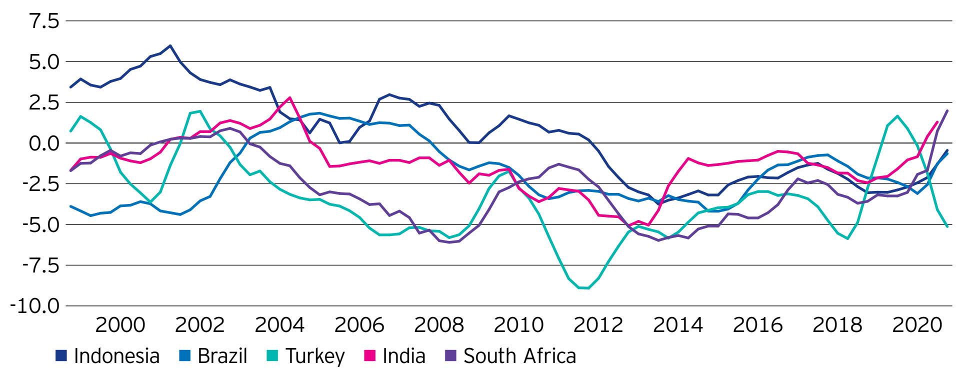
Within this framework of global growth recovery supported by accommodative monetary and fiscal policy, the market pricing of risk and the path of interest rate increases will likely be critical in generating excess returns going forward. Our investment theme for the next nine to 18 months (our investment horizon) is reflation and growth. In the absence of tightening financial conditions, all growth will remain "good" growth for reflationary assets, in our view. Reflationary assets include emerging market equities, currencies, rates, and to a lesser extent, credit. We believe commodity-based assets and assets that benefit from steeper yield curves, such as banks, will be the largest beneficiaries of reflationary conditions.

Stable emerging market policies may create opportunities in rates and currencies

In emerging markets, mainly due to "recency bias," there tends to be a perpetual fear that global growth will lead to policy responses that will result in negative asset performance. We believe this pervasive fear has kept emerging markets premia too high and can be extracted within our investment horizon. Emerging markets of today are not the emerging markets of 2013. Their external accounts are in significantly better shape, currencies are at attractive valuations, in our view, and capital flows were quite negative in 2020, meaning there is less potential for capital flight.

In 2013, the narrative centered on high current account deficits among the so-called "fragile five" (Brazil, India, Indonesia, South Africa, and Turkey), a group of countries considered highly dependent on foreign investment for growth. Today, in contrast, India, for example, is receiving record foreign direct investment, and the Reserve Bank of India has managed to increase its foreign exchange reserves by USD100 billion in just the last year.

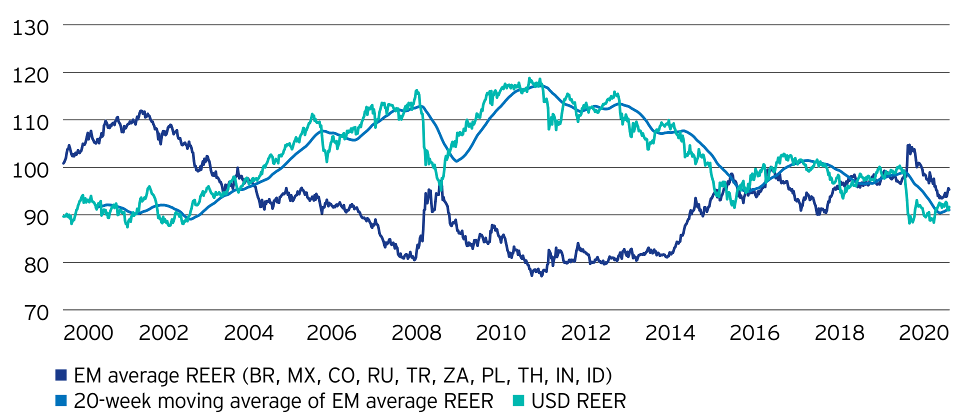
Figure 3: Current account (% of GDP)



Source: Bloomberg L.P. Data from January 1, 2000, to October 1, 2020.

Also, in 2013, there were large misallocations of resources in emerging markets due to large capital inflows, which led their currencies to become expensive on a real effective exchange rate basis. That is not the case today. Emerging market currencies remain close to multi-decade lows on a real effective basis. As Figure 4 shows, not only were emerging market currencies expensive in 2013, but the US dollar was very cheap on a real basis. Today, while the US dollar is not at its highs, it is expensive on a real effective exchange rate basis, in our view. Absent an early policy tightening in the US (essentially, a policy error by the Fed). We believe valuations in emerging market currencies offer potentially compelling opportunities and returns.

Figure 4: Average real effective exchange rates for emerging markets and the US



Source: Bloomberg L.P. Data from March 31, 2000, to March 12, 2021. Countries are Brazil, Mexico, Colombia, Russia, Turkey, South Africa, Poland, Thailand, India, Indonesia. REER is real effective exchange rate.

Aggregate pricing in emerging market rates is also compelling, in our view. After the recent wobbles led by increases in US interest rates and matched by most emerging markets, yield curves have steepened to decade-highs and offer attractive carry and roll down, i.e., "static return," in our view. While we believe steepening yield curves in developed markets are required and welcome, emerging market yield curves were already very steep, and this latest steepening has created attractive potential value, in our view.

Figure 5: Emerging market yield curve (10-year bond yields vs overnight rates) in selected high-yielding countries

Source: Bloomberg L.P. Data from April 29, 2015, to April 5, 2021. Average of 10-year bond yields less overnight rates in Mexico, Colombia, Russia, South Africa, Indonesia, and India.

The market narrative continues to revolve around US exceptionalism and higher US real yields as a transmission mechanism to tighter financial conditions in emerging markets. The narrative is focused on relative growth differentials rather than global reflation. Reflation would have a salubrious effect on most emerging market assets, including interest rates, by reducing the real yield premium vis-a-vis developed markets.

We believe the market narrative will shift as it becomes clear that there will be no near-term policy response to higher global growth from developed market central banks. This shift will likely be accelerated by the tightening policy response in certain emerging market countries such as, but not limited to, Brazil and Russia. This double-edged response will likely reduce the real premium embedded in emerging rate markets, as seen in Figure 6.

Figure 6: 10-year real yield differential between selected emerging and developed market countries

Source: Bloomberg L.P. Data from July 1, 2015, to March 19, 2021. Emerging markets: Brazil, Mexico, Colombia, South Africa, India, Indonesia. Developed markets: US, Europe, UK, Japan, Australia.

In addition to emerging market assets, we believe other assets linked to the reflationary theme, such as commodities, will benefit. Given the low level of real and nominal interest rates in developed markets, we believe return premia can best be extracted through the equity and currency markets, and to some extent, credit, which will likely be negatively impacted by persistent interest rate volatility. Commodity-sensitive countries such as Australia, Korea, Chile, and Canada will likely especially benefit from the global reflation currently underway.

The new "p" (path dependency) and portfolio positioning

The pricing of risk cannot be divorced from the path dependency of policy response, which is the primary reason that rate markets have become inherently more volatile and are likely to remain so. If the major developed central banks do not tighten policy in 2021 and 2022 (our expectation), then the interest rate path currently embedded in numerous developed market yield curves, including Canada's and Australia's, will likely not be realized, making those term premia attractive, in our view. If, however, policy "lift-off" occurs earlier in many countries than the premia currently imply, the premia, while still quite attractive, would be within normal historical boundaries. This makes markets vulnerable to changes in path expectancy, in our view, a feature that is not likely to go away over the next nine to 18 months.

This path dependency has also created potential opportunities in certain emerging markets. In several countries, such as India, Indonesia, Thailand, Mexico, and Colombia, the market pricing of the potential policy response is elevated, especially if the current Fed path is not repriced to include earlier rate hikes and the Fed does not make a policy error.

Conclusion

Based on the above macro and market expectations and our analytical framework, the Global Debt Team intends to focus on taking risk in reflationary assets, according to the following approach:

Interest rates

- Our focus is on emerging market interest rates and developed market yield curves where excessive risk premia are priced into the interest rate structure.
- We favor low duration assets since interest rate volatility will likely remain elevated with a bias toward higher interest rates.
- We favor positioning for steeper yield curves, specifically in countries where inflation is likely to remain at or below target (i.e., the central bank is unlikely to hike rates).

Currencies

- We are focused on emerging market currencies based on valuations.
- We favor countries that are likely to benefit from global reflation and reopening.
- Given our expectation of limited or no policy response to higher growth, we expect the US dollar to generally weaken over the next nine to 18 months.

Credit

- We are less favorable on global credit.
- We are focused on sectors likely to benefit from reflation and reopening, such as financials, which should benefit, in our view, from steeper yield curves and improving credit quality.
- In emerging market credit, we are focused on assets likely to benefit from reflation.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Past performance is not a guide to future returns.

Fixed income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The values of junk bonds fluctuate more than those of high-quality bonds and can decline significantly over short time periods.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

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All data as of March 31, 2021, unless otherwise stated. All data is USD, unless otherwise stated.

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